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WHEELS WITHIN WHEELS: Rethinking the Asian Crisis and the Asian Model

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■ **Abstract** The East Asian economic crisis of 1997–1999 had its causes not mainly in the "East Asian model" nor even in departures from the model, but in international capital markets and the governments of the core economies, especially the United States and Japan. The post–Bretton Woods system, without any link between the dollar and gold, allowed the United States to finance persistent external deficits by creating US government bonds. These bonds raised the foreign reserves of the surplus countries, notably Japan and East Asia. The rise in reserves triggered credit booms that generated asset inflation and industrial overcapacity. The booms gave way to crisis. The East Asian variant differed from the earlier Japanese one by being fueled by very large capital inflows in the early to mid 1990s from recession-hit Japan and Europe, as well as from the United States. This perspective, which highlights causes outside of East Asia, suggests that emerging market economies will remain vulnerable to such crises in the absence of capital controls, a different system of international payments, and a more equal world income distribution. It also suggests unexpected directions for political science research.

> To its credit [Korea] has acknowledged its faults with remarkable candour. It has not tried to blame foreigners for its troubles, nor has it hid behind tariff barriers or currency controls. Instead, it has pledged to abandon the economic system that took it from poverty to prosperity in a generation. (*Economist* 1999)

> The Korean economy is another kind of leftover Cold War artifact, good for an era of security threats and close bilateral relations with Washington but of questionable use in the global "world without borders" of the 1990s.... It is a highly leveraged, highly political, manifestly corrupt nexus between the state and big business.... [It] has always been intrinsically unstable and therefore vulnerable to exactly the sort of financial calamity that has now befallen it. (Woo-Cumings 1997)

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INTRODUCTION

During the year following mid 1997, several East Asian economies—especially South Korea, Thailand, Malaysia, and Indonesia, combined population nearly 350 million—went haywire. Their currencies and stock markets plunged, banks failed, real interest rates shot up, exports fell, imports fell by even more, firms shut down, people who had worked at regular jobs for 10 or 20 years suddenly found themselves on the street, and anxiety took hold. It became not merely a crisis but a collapse, perhaps the world's steepest and deepest since the Great Depression (apart from natural disasters, famines, wars, and transitions from communism).

Yet these same economies had until then constituted "the East Asian miracle" (World Bank 1993). By the 1990s, their fast economic growth was one of the certainties of our age. They had been growing at 5–10% a year for decades. Korea had not had a year of significantly less than 5% real growth in its gross domestic product (GDP) since 1980, Thailand not since 1972. Add in China growing at over 9% a year since the mid 1980s, and nearly 30% of the world's population experienced a doubling of GDP every decade or so—unprecedented in human history. Add in Japan, and by the early 1990s, the region accounted for a quarter of world output, half of world growth, and almost two thirds of world fixed capital investment. In 1990–1996, residents of Taiwan, South Korea, Singapore, and Hong Kong (combined population 73 million) took out almost 19,000 patents in the United States, compared with 1100 for the top four Latin American countries, 1300 for the whole of east and central Europe, 20,000 for France, and 17,500 for Britain (both with populations of 58 million).

Through the 1980s, Asia, led by Japan, seemed set to become an equal leg of a tripolar world with North America and Europe. The United States seemed a diminished giant—the world's biggest debtor nation, dependent on a continually depreciating dollar to sell its exports and on Asian savings to fund its deficits, constrained militarily by the "Vietnam syndrome," and unable to sustain political coalitions of support in the United Nations and other multilateral organizations. Latin America after 1982 hardly counted except as a place from which to collect debts. The whole of the western hemisphere was being eclipsed. On the other side of the Atlantic, Europe appeared introspective, enfeebled by low growth and high unemployment and dependent on the Americans even for its defense. To many commentators, both western and Asian, it was increasingly unclear how the West could claim superiority for its neoliberal model when the results in terms of economic growth, income distribution, education, and social cohesion looked manifestly inferior to Asia's (Foot & Walter 1999).

By the late 1980s, commentators began to ring the arrival of the "Pacific Century" and the premature close of the "American Century," whose beginning had been proclaimed as recently as 1945. Books appeared with titles like *Pacific Century, Pacific Rising, Pacific Destiny, Megatrends Asia*, and *Asia Pacific*. The audacity of it all was symbolized by sleepy Kuala Lumpur launching a bid for world city status by planning not just the tallest building in the world but the two

tallest buildings in the world, the 88-story twin towers of Petronas, the state oil company.

The crisis shocked the world not only because it happened in the context of sustained success but also because it did not result from the things that are thought to be the normal causes of economic crisis in developing countries—bad "fundamentals," meaning fiscal deficits, trade deficits, and inflation. It was unanticipated in both onset and severity. Even worse, unlike earlier crises of developing countries, it seemed to threaten the stability of the international financial system itself. As a result, the Asian crisis has spawned more discussion of the redesign of the rules of global finance and of domestic financial systems than any crisis since the Depression. Some commentators dubbed it the first twenty-first century crisis.

The "official-academic" consensus on the crisis was that, although its causes were not the standard ones, they were, nevertheless, still mostly "homegrown" (Fischer 1998). Deputy US Treasury Secretary Lawrence Summers explained, "[This crisis] is profoundly different because it has its roots not in improvidence but in economic structures. The problems that must be fixed are much more microeconomic than macroeconomic, and involve the private sector more and the public sector less." Most of the political science literature on the crisis accepts the idea of mostly homegrown causes. (Collections on the crisis include *Cambridge Journal of Economics* 1998, Jomo 1998, *World Development* 1998, *IDS Bulletin* 1999, and Pempel 1999. See also Cumings 1998; Lim 1998; Doner 1999; Henderson 1999; Putzel 2000; Weiss 1999, 2000; Yoshitomi & Ohno 1999.) This literature concentrates on identifying the political causes in each country and sometimes goes on to compare why events happened one way in one country, another way in another. Like the broader official-academic consensus, its leitmotif is failure of Asian governance. The Asian model, it says, worked for a time but then stopped working; hence the crisis.

In this essay I explain the weaknesses of the "failure of Asian governance" theory. I then outline an alternative, the "failure of international financial markets" theory, which says that the Asian crisis is only one in a series of financial crises that have rotated around the zone of countries closely integrated into world capital markets during the late 1980s and 1990s, especially in weakly institutionalized "emerging market" economies (developing countries of interest to international investors). The crises tend to be associated with an open capital account and large foreign capital inflows, producing a credit bubble, which sometimes ends in crisis. Regional and national factors have some influence over where and when the credit boom blows out and the form that the blowout takes; but the dynamics of core economies and international capital markets are deeply implicated in the phenomenon itself.

Think of the metaphor of wheels within wheels. The Asian crisis can be explained partly by the motion of the inner wheels, the trends in national and regional variables. But the overall result was driven more by the motion of the outer wheels and the tighter integration between inner and outer wheels made in the 1990s. At

the end of the essay I outline some issues for political science research highlighted by this metaphor.

THE "FAILURE OF ASIAN GOVERNANCE" THEORY

The trigger of the crisis, everyone agrees, was the sharp reversal of private capital flows starting in mid 1997. Net private inflows of about $93 billion in 1996 to Korea, Thailand, Malaysia, Indonesia, and the Philippines became net outflows of about $12 billion in 1997, the $105 billion turnaround amounting to 11% of combined GDP. No economy can withstand such a whiplash withdrawal of capital without severe disruption.

The key question is why the private capital inflows were so "excessive" (as defined after the event). According to the official-academic consensus, the reasons were (*a*) "lack of transparency" in company and bank accounts, which meant that institutional investors could not know the truth about the position of their borrowers; (*b*) "weak prudential regulation" by the monetary authorities, which allowed banks to lend to heavily indebted companies; (*c*) "poor" exchange rate management, meaning commitment to a fixed exchange rate, which seemed to rule out foreign exchange risk, making foreign borrowing too cheap; and (*d*) "moral hazard," meaning that investors expected that the banks and firms they were lending to would be bailed out by the Asian governments ("implicit guarantees"). These causes are themselves the consequences of East Asia's "cronyistic"—or less pejoratively, "relationship"—system of economic governance. In this system, (*a*) banks rather than capital markets intermediate finance, (*b*) banks, big firms and governments have close and long-term relations, and (*c*) agreements are made behind the scenes, unmonitored by independent parties and unenforced by courts, and the government has a direct influence on who gets credit and other support. This system resulted in inefficient investments that could not repay the foreign financial claims piling up against them.

In the words of Federal Reserve Chairman Alan Greenspan, crisis-afflicted Asia suffered from "a free market veneer over a state-managed economic structure," which has "inevitably led to the investment excesses and errors to which all similar [state-influenced] endeavors seem prone" (Sanger 1998). In the echoing words of the managing director of the International Monetary Fund (IMF), Michel Camdessus, "countries must take great care to ensure that their affairs are conducted in an irreproachable and transparent manner and that all forms of corruption, nepotism, and favoritism are shunned; yet, over time in Asia, these afflictions took hold and overpowered systems that were otherwise remarkably successful" (Camdessus 1998).

The consensus within each crisis-affected country has tended to focus on the country's crisis as a singular event with country-specific causes. Indonesians and foreign Indonesian experts talked of "the Indonesian crisis" and found its causes in, for instance, the Suharto family's cronyism. Koreans and foreign Korean experts

talked of "the Korean crisis" and found its causes in the misdeeds of the Kim Young Sam government and its corrupt relations with some of the conglomerates, or in more structural and long-lasting problems. "The cause of the crisis was our disrespect for the rule of law," declared the governor of North Cholla province (You 1999). "The Korean economic system has always been intrinsically unstable, and therefore vulnerable to exactly the sort of financial calamity that has now befallen it," claimed the US-based Korean political scientist Meredith Jung-en Woo-Cumings (1997).

The nearly unanimous conclusion among both US and Asian policy elites was that the national model (for those with a national focus) or the "East Asian" model (for those with a regional focus) had outlived its usefulness. Korea, Indonesia, and the others had become too complex, or too corrupt, for the economy to be "intervened" in as in the past. Moreover, internal evolution aside, such intervention could no longer work in the new realities of global capital markets. The crisis was merely the messenger delivering the wake-up call to effect radical structural reforms and establish "sound" institutions and policies in banking, capital markets, corporate governance, labor markets, and the like. "Sound" is code for "consistent with the prescriptions of the Washington Consensus," that is, consistent with the Anglo-American model of a free market economy with (*a*) arms-length relations between banks, firms and government, (*b*) regulation by formal contracts enforced in courts of law, and (*c*) capital market as the basis of the financial system. "Sound" further implies consistency with a policy configuration of small government, low taxes, low budget deficits, low welfare spending, and very low inflation.

But interpreting the Asian crisis is not merely an academic debate. For many American commentators, the crisis was cause for celebration. First communism had been defeated, and now the Asian alternative too. The Pacific Century was dead; the American Century was back. "The sudden collapse of Asia's house of cards," said one journalist, "is beginning to be seen as the end of an outdated economic and political system based largely on the mercantilist, government-run Japanese model—much as the fall of the Berlin Wall symbolized the demise of communism" (Dale 1998). Henry Kissinger, former US Secretary of State, warned, "Even [Asian] friends I respect for their moderate views argue that Asia is confronting an American campaign to stifle Asian competititon. It is critical that at the end of this crisis, when Asia will reemerge as a dynamic part of the world, America be perceived as a friend that gave constructive advice and assistance in the common interest, not as a bully determined to impose bitter social and economic medicine to serve largely American interests" (1998).

Many of the proponents of the failure-of-Asian-governance theory had earlier championed the idea that Asia was successful because of free markets and good economic management, and they were none too careful to reconcile their discovery of basic flaws in Asian capitalism with their earlier explanation of success. But the theory served western interests well. For all their devotion to the principles of free trade and the division of labor, many in the West regarded Asia's rise as a threat. As the Cold War wound down, they saw economic issues becoming more important

determinants of a country's overall power status than the traditional military ones, and it appeared easier for economic superpowers such as Japan to gain leverage over security issues than for military superpowers such as the United States to gain leverage over economic issues. These observers worried about Japan's growing economic dominance in fast-growing Asia, dominance that seemed to be related to the ability of its government and businesses to operate in the "cronyistic" or "relationship" system better than the shorter-term and formal-contract-oriented western governments and businesses could. The West needed to find ways to encourage Asia to make its economic institutions more congenial to western firms and governments.

Moreover, the failure-of-Asian-governance theory implies that western and Japanese investors acted responsibly—rationally—in lending as much as they did. Since only irresponsible investors deserve not be repaid, the theory underwrote the moral obligation on Asian debtors to repay foreign investors. And since international capital markets had no more than a secondary role in the crisis, not much had to be done by the governments of developed countries or by international organizations to change the regime under which their banks and institutional investors worked internationally. The theory implies that more transparency is needed in corporate and governmental accounts, certainly, and that the IMF should exercise closer surveillance of developing countries (though not of the major industrial countries).[1] But such expensive innovations as an international lender of last resort are not needed, nor restrictions on western institutional investors, nor capital controls in developing countries. Small changes at the international level and in the source countries are enough to protect the tendency of capital markets toward benign equilibrium. In the words of Michel Camdessus, "A lack of transparency has been found at the origin of the recurring crises in the emerging markets, and it has been a pernicious feature of the 'crony capitalism' that has plagued most of the crisis countries and many more besides." Therefore, "[t]here is a strong consensus for making transparency the 'golden rule' of the new international financial system" (Camdessus 1999). With this golden rule in place, capital markets will be stable and deliver big net benefits to developing countries open to them. This is a key assumption of the failure-of-Asian-governance theory.

EVIDENCE FOR THE "FAILURE OF ASIAN GOVERNANCE" THEORY

Those who advance the failure-of-Asian-governance theory, including many Asians, find it attractive because it justifies strong market-liberalizing changes ("reforms") in Asia and exonerates foreign investors, foreign governments, and

[1]In August 1999 the IMF Board was considering a report that urges strengthened IMF surveillance of developing countries. The report suggests that the developed countries are already well enough covered by other bodies.

the international financial regime (Woods 1995). This is why it became the standard explanation even though it meets the normal criteria of evidence not much better than its epistemological cousin, the theory of witchcraft.

A key argument of the theory is that "lack of transparency" (including lax government enforcement of disclosure laws) was an important cause of the crisis. To accept this argument, we need evidence supporting the following assertions:

1. Information was lacking on variables that are strongly associated with impending crisis.
2. Had investors known this information—and registered it as indicating a rising probability of crisis—they would have invested significantly less money.
3. The crisis-affected countries had become significantly less transparent over the 1990s.
4. The crisis-affected countries were less transparent than non-crisis-affected comparator countries.
5. In the set of financial crises from the late 1970s onwards, a low level of transparency is associated with crisis and a high level of transparency is associated with non-crisis.

The IMF, the US Treasury, and other proponents of the argument provide no evidence. With reference to Asia, plenty of information about relevant macro variables was publicly available. There is no evidence of systematic misreporting of macro variables relevant to crisis. Most of the relevant data about Thailand's foreign debt was easily available in the two years before the crisis. Everyone knew about the real estate bubble and its financing out of short-term foreign debt. Everyone knew about Indonesian corruption. Everyone knew about Korea's high corporate debt-to-equity ratios (Furman & Stiglitz 1998).

All that we know about capital markets suggests that even had investors been sure of an eventual crisis they would not have lent less today if profits looked good and exit looked open; they would have waited until the last week.

Data on trends in transparency over the 1990s hardly exists. But evidence on people's assessments of corruption—which can be seen as a subset of lack of transparency—shows no increase in perceived corruption in Asian countries in the run-up to the crisis; indeed the corruption score went down in Indonesia and Korea during the 1990s (see Figure 7 in Furman & Stiglitz 1998).

Even if actual transparency did not deteriorate, crisis could still be caused by lack of transparency if international investors began to attach more importance to transparency and therefore weighted the constant level more negatively. But if they gave a more negative weighting, one would expect risk premiums to rise. In fact, risk premiums fell right up to the onset of the crisis.

Within Asia, lack of transparency does not begin to differentiate between the crisis countries and the non-crisis countries. The crisis countries—Korea, Thailand, Malaysia, and Indonesia—all had strongly negative GDP growth in 1998.

The non-crisis countries—Taiwan, China, India, Sri Lanka, and Bangladesh—had significantly positive growth in 1998. One would be hard put to argue that China and India had greater transparency than Korea and Malaysia. Lack of transparency is clearly not a sufficient condition of crisis. Neither is it a necessary condition. Two paragons of transparency have had serious financial crises, namely the United States' Savings and Loan crisis of 1984–1991 and Scandinavia's much bigger currency-cum-banking crisis in the late 1980s to early 1990s.

The transparency argument occludes the information failures of capital markets. Investors were ignorant not mainly because information was falsified or unavailable but because they were not paying attention to what was available. They were not paying attention because their incentives to gather and process information on individual countries in order rationally to assess risks and returns are quite low. The incentives are low because it is easier and cheaper for investors to see what others are doing and herd along—especially if the countries have open capital accounts that allow them to get their money in and out very quickly. "It is very hard to find people who think independently about how to invest in Asia. They are terrified about underperforming the benchmark," said a former Asian fund manager to explain why regional stock indexes, supposed indicators of investor behavior, drive investor behavior (Landler 1999).

The managing director of the IMF calls for transparency as the centerpiece of a reform strategy for the world financial architecture. But the evidence is simply not there. This is not to deny that poor-quality information, especially in the accounts of companies and banks, may have worsened the crisis by making it difficult for investors to distinguish between more and less sound entities, thereby contributing to a panicky rush for the exits; or to deny that countries that seek to integrate fully into world capital markets do need to improve the quality of their macro- and firm-level financial information in order to discourage "excessive" inflows and to check the magnitude of panic once a pullout begins. Institutionalizing robust transparency, however, takes years, perhaps decades. If so, the logic of Camdessus' own argument about transparency implies that countries that fall short on the transparency dimension should go very slowly in their integration into world capital markets. Camdessus, however, is one of the strongest advocates of fast financial integration. He assumes that robust transparency can be quickly achieved.

Similarly unsupported is the argument that "weak prudential regulation of Asian banks" was a major cause of the crisis—meaning that basic prudential rules limiting lending to affiliated companies were regularly broken, banks were undercapitalized, and the share of nonperforming loans in total loans was high or else concealed. If weak prudential regulation was a major cause, we should find that the banking systems of the crisis countries were in worse shape than those of non-crisis countries and became worse during the 1990s. Moody's Investor Services ranked banks on a quality index in 1996. The ranking shows little to distinguish the quality of banks in the Asian crisis economies from those in non-crisis emerging

markets [B Bosworth (unpublished) cited in S Radelet, J Sachs (unpublished)]. According to data from the Bank for International Settlements (1997), banks in Malaysia and Indonesia were stronger in 1997 than they had been a few years earlier (as indicated, for example, by the falling share of nonperforming loans). Furthermore, if weak prudential regulation was a major cause of the crisis, it should also be the case that the strength of prudential regulation is largely independent of the volume of capital inflows. But in fact, as explained below, the strength of prudential regulation is partly a function of the volume of capital inflows.

The underlying argument about the relationship model of capital allocation implies a large and general deterioration in investment quality in East Asia in the years leading up to the crisis. One measure of investment quality is the incremental capital-to-output ratio (ICOR). ICORs for the four main crisis countries did indeed all rise starting around 1991, indicating some decline in returns to capital (see Figure 2.7 in World Bank 1999). But in longer perspective, the ICORs moved cyclically and synchronously between the East Asian countries from the early 1970s onward. By 1996, they had not exceeded the upper end of their range over the previous 25 years.

Moreover, the deterioration of investment in the crisis countries during the 1990s might plausibly be attributed to an investment boom. Their ratios of gross domestic investment to GDP in 1991–1996 were 5–10 percentage points higher than in the preceding 15 years. All economies tend to experience some deterioration in investment quality during an investment boom, whether they have a relationship model of capital allocation or an "efficient," arms-length, formal-contract model. The fact that the Asian economies experienced some deterioration in investment efficiency does not necessarily indict the relationship model itself.

The accounting rate of return on assets of non-financial corporations is another measure of investment efficiency. By this measure, too, the results conflict with the official-academic consensus. Average returns in most East Asian countries over the period from 1988 to 1994 had run at a relatively high rate of ∼5–8%, compared with ∼1–3% in the advanced industrial countries. Japan and Korea were the exceptions among the East Asian economies, with a rate of ∼2%. The corresponding US rate was 2.3% (Claessens et al 1998, Chang 1998).

Rates of return in most of the crisis countries did fall sharply between 1995 and 1996. The fall was probably due to the slowdown in economic growth that most East Asian countries experienced at this time (part of the world-wide slowdown of 1996) and to the normal build-up of vulnerabilities in the late stages of an investment boom. The fall in rates of return might well have had an important role in triggering the panic of 1997. But it is difficult to argue that the fall in rates of return in 1995–1996 was the result of long-standing structural distortions attributable to the relationship model of capital allocation.

If space permitted, the same kind of exercise would show that the popular "moral hazard" argument about the crisis has no more empirical support than its cousins.

THE "FAILURE OF INTERNATIONAL FINANCIAL MARKETS" THEORY

A plausible explanation of the Asian financial crisis has to accommodate several big facts. First, currency and/or banking crises have become much more frequent since 1980 than they were in the period after World War II. From the late 1970s to 1996, at least 69 countries had at least one major banking crisis (the net worth of the banking system sank to zero or less). The inclusion of countries of the former Soviet Union and some other cases where the data are not fully satisfactory would raise the figure to nearly 90. Between 1975 and 1995, at least 87 countries had at least one major currency crisis (depreciation by more than 25% in one year). In at least 10 of these cases (excluding the Asian cases of 1997–1998), banking and currency crises occurred together, causing very large falls in GDP [5–12% in the first year and negative or only slightly positive growth for several years thereafter (Caprio & Klingebiel 1998, Furman & Stiglitz 1998)]. A second crucial fact is that crises have commonly occurred in response to "success"—the Wall Street crash of 1929 being the most dramatic example. So we should not assume, as the usual story does, that if Asia had a crisis there must be flaws in the basic structures of Asian capitalism. Third, the Asian crisis was regional, with several countries falling into a pile at about the same time. Fourth, as noted above, the crisis was unanticipated by those whose job it is to anticipate such things (with the partial exception of Thailand, where by 1996 there was more of a consensus of recession ahead). To develop an explanation of the Asian crisis that accomodates these facts, we need to move away from Asian specifics.

A General Story of Financial Fragility

Start with the general tendency in capitalist economies for economic activity to move in cycles, with financial crisis as part of the cycle. A plausible reason for this tendency is as follows (Minsky 1982, Veneroso 1999). In the upswing (which might be started by large capital inflows), the financial system tends to become more fragile, for reasons inherent in the upswing process itself rather than in relationship governance or other political variables. Investment relative to GDP tends to rise above trend, and the proportion of investment financed by debt (rather than retained earnings or sale of equity) tends to rise. Higher corporate debt-to-equity ratios make for more financial fragility than do lower ones, because debt must be repaid as a proportion of the debt irrespective of the level of profits (or ability to repay), whereas equity must be repaid as a share of whatever profits happen to be.

Other factors amplify the tendencies towards financial fragility. When fiscal policy is countercyclical, the boom lowers the government's fiscal deficit, so the government borrows less; more of household savings are therefore intermediated through banks to firms, ending up boosting corporate debt-to-equity ratios. The expectations of business managers, investors, and consumers tend to become

extrapolative (everyone expects the boom to continue indefinitely) and then euphoric, so economic agents reduce their cushion of reserves with which to counter a downturn. Under these conditions, a standard policy response—raising interest rates to slow demand—may cause debt-to-equity ratios to rise even further as higher interest rates reduce retained earnings and as firms, wishing to continue to invest at above-trend rates, borrow more to offset the fall in retained earnings. Where the equity market is significant, more equity finance reduces financial fragility, other things being equal; but in the presence of extrapolative expectations, equity price bubbles easily develop, people borrow more against rising equity values, investment goes up, and financial fragility is compounded. If corporate managers are compensated in stock options, they have an incentive to boost the stock price, which may lead them to buy in equity in order to make it scarcer and substitute the equity with borrowed funds, resulting in higher debt-to-equity ratios (as in the United States during the 1990s).

All this concerns a closed economy. When the economy is relatively small and open to imports (as are most of the emerging market economies), the boom causes imports to rise, causes the current account deficit to rise, causes rest-of-world savings to flow in to finance the deficit, causes the real exchange rate to appreciate, and causes the profits of companies in the tradeable goods sectors to fall. When, in addition, the capital account is open and domestic interest rates are much higher than interest rates in capital-surplus economies, the boom sucks in much more capital than is needed to finance the current account deficit, as foreign investors rush to diversify their portfolios and follow the herd. Euphoric expectations take hold.

When the private capital inflows rise above what is needed to finance the current account deficit, the central bank's foreign exchange reserves rise too (assuming that the exchange rate is not left to float). Or, if the country is running large current account surpluses and does not reexport sufficient capital (e.g. Japan after 1986), the surpluses translate directly into higher reserves. Whatever the cause of the higher reserves, the domestic financial system, especially in developing countries, will probably be unable to offset or neutralize ("sterilize") the increase, that is, unable to prevent the increased foreign exchange reserves from feeding through into an increase in the domestic money supply. When a foreign investor takes his currency (US dollars) to the central bank in order to buy domestic currency (baht), he receives baht. This makes a net increase in the supply of baht in circulation. To offset or sterilize this increase in the money supply, the central bank or treasury could undertake "open market operations"—sell government baht bonds in the market, receive baht in return, and take that baht out of circulation.

However, sterilization has at least three big problems. First, it is typically expensive, because the interest the central bank or treasury has to pay on the baht bonds is higher than the interest it earns from the foreign bonds it buys with the US dollars (typically low-interest US Treasury bills), whereas without sterilization, the central bank gets interest income on its US bonds with no interest expense at all. Second, in a developing country, sterilization may not be feasible

because the market for government bonds and bills in the domestic currency is small and the range of other financial instruments is also small. (Indeed, to the extent that the government sells the baht bonds to banks rather than to other investors, the bonds become part of the banks' money base, along with cash, and can be used to support bank credit creation. So even sale of sufficient government baht bonds to absorb all the extra baht released by the conversion of the original US dollars into baht may still not prevent a capital inflow from increasing the domestic money supply.) Third, to the extent that sterilization does succeed in lowering the money supply relative to the unsterilized level, it raises interest rates—which perpetuates the inflows. In short, sterilization is anything but a straightforward solution to the problems of capital inflows.

The capital inflows therefore tend to generate excess liquidity in the form of a domestic credit boom: The money supply increases faster than the output of goods and services. The credit boom may "vent" itself through (*a*) a surge in consumer goods imports, which widens the current account deficit; (*b*) inflation in consumer goods prices (CPI inflation); (*c*) a surge in "investment" in asset markets, notably real estate and stocks, causing asset price inflation; and/or (*d*) a surge in industrial investment, reflecting an assumption that the resulting increase in production can be exported if not sold at home. The surge in industrial investment also manifests itself as a widening of the current account deficit through higher capital goods imports.

In relatively open economies, there are limits to the inflationary response, because as domestic prices rise and the real exchange rate appreciates, imports will be sucked in. Where consumption propensities are high, a credit boom is likely to manifest itself as a surge of imported consumer goods. This causes a sharp deterioration in the current account that is not matched by prospects of additional foreign exchange earnings in the future. Where savings propensities are high, on the other hand, a credit boom is likely to vent itself in some combination of (*a*) increased capital goods imports, justified initially on the grounds that the imports are sustainable because the borrowing country will be able to repay the capital inflow from the increased output; (*b*) asset price inflation, e.g. property and stock market bubbles; and (*c*) increasingly speculative expansion of industrial capacity fueled by too-cheap foreign borrowing and export optimism.

Such an economy is now primed with multiple sources of endogenously generated financial fragility, including some or all of the following:

1. a rate of increase of productive capacity above trend (above labor force growth and productivity growth), perhaps amounting to an industrial capacity bubble;
2. a relatively high and rising ratio of corporate debt to equity;
3. an asset price bubble;
4. a smaller cushion of safety held by all economic agents in the grip of extrapolative expectations;

5. a high and rising current account deficit;
6. relatively high and rising external debt (which must be repaid out of foreign exchange earnings).

Under these conditions, devaluation, increases in interest rates, and decreases in demand can tip whole swathes of the corporate sector into illiquidity. Quite small shocks—e.g. rumors of increases in Japanese or US interest rates or sudden downturns of export earnings—can now precipitate financial crisis in the form of a forced devaluation or a cascade of credit contraction and debt defaults. Foreigners begin to repatriate their investments, residents begin to shift their savings overseas, speculators sell the currency forward, all helping to trigger the crisis.

The East Asian Model

In this general story of how a successful capitalist economy can become financially fragile and then financially unstable, the next step is to show how East Asia managed to avoid these crisis dynamics until the 1990s, while growing very fast. Begin with the formulation of the model given above: (*a*) Banks, rather than capital markets, are the central financial entities; (*b*) banks, big firms, and governments have close and long-term relations; and (*c*) agreements are made behind the scenes, unmonitored by independent parties and unenforced by courts, and the government has a role in determining who gets credit and other support. This could be called alliance capitalism or relationship-based economic governance, distinct from formal-contract-based or rule-based governance. The model applies more fully to northeast Asia than to southeast Asia.

Relationship-based governance has some economic development advantages over a formal-contract–based system. Agreements can be enforced outside of a formal legal system, allowing the economy to avoid the social costs of the elaborate institutional arrangements of rule-based governance; hence the economy has lower average transactions costs when the number of major players is small (S Li, "The Benefits and Costs of Relation-Based Governance: an Explanation of the East Asian Miracle and Crisis," unpublished).

But at this level of generality many other emerging market economies have broadly similar institutional arrangements. How could relationship-based governance go with sustained fast growth in East Asia as compared to, say, Latin America? The fast growth resulted from the coming together of this institutional structure with rates of saving and investment much higher than in other regions. Most of the saving is done by households, which deposit most of their savings in (low-risk) banks. The banks are treated as akin to public utilities, serving a public purpose even when privately owned, and are regulated to secure that purpose; their collective performance is judged less by their profitability than by their service to other sectors. Corporations finance their investments in large part by borrowing from banks. The thinness of securities markets means that banks need to develop close relations with their big borrowers, because if a borrower goes into difficulties,

the bank does not have the option of selling the loan on a securities market. Corporations' ability to borrow multiples of their equity and not be constrained by retained earnings or by the risk preferences of equity buyers partly explains the extraordinarily high levels of investment and the massive change in the composition of manufacturing output toward the fastest growing sectors, electronics and machinery.

The institutional arrangements of the relationship model help to counter the tendency toward financial instability inherent in an economy experiencing high (above-trend) levels of investment and high corporate debt-to-equity ratios. The long-term relations between banks and firms provide a buffer so that banks do not call their loans and pitch firms into bankruptcy when they run into liquidity difficulties, as they might in a more short-term, formal-contract-based model. Also, the government stands ready to support both firms and banks in the event of shocks that affect swathes of the economy at once (such as sharp rises in interest rates or sharp falls in demand)—but not unconditionally. The government steers its support by an industrial policy that seeks to promote certain investments ahead of others and to overcome the "coordination failures" endemic to free markets when the physical capital endowment is not already large.[2] On the other hand, firms' and banks' dependence on the government's support gives it capacity to implement the industrial policy. (See Rodrik 1995, the single best explanation of "getting interventions right" in East Asia. Other important references on the role of the state in East Asian development include Evans 1995, Kohli 1994, Weiss 1998, Woo-Cumings 1999, Lall 1998, and others cited in Wade 1992.) The exposure of many firms to export markets and the overarching importance given to exporting helps to discipline the government, the banks, and the firms so that relationship-based governance, with only weak (impersonal) mechanisms of monitoring and enforcement, does not necessarily (*pace* Greenspan, Camdessus and others) degenerate into inefficiencies and cozy rental havens to the point of outweighing the economy-wide savings on average transactions costs. The export orientation is a necessary condition of the continued high rates of investment, given less than continental-sized economies.

In sum, close and long-term relations between banks, firms, and governments help to prevent one of the strengths of the East Asian model—high investment sustained by high corporate debt-to-equity ratios—from becoming a source of financial instability. These relations help the government to overcome otherwise endemic coordination failures. The emphasis on exporting helps to discipline those close and long-term relations in line with a national interest test, and allows continued high rates of investment to be validated in sales.

Another important stability condition of the model is a restricted movement of financial capital across the national borders. Foreign exchange can be bought and

[2] A coordination failure occurs when an investor fails to invest because he cannot be sure that other, uncoordinated investors will undertake the complementary investments needed for his investment to succeed.

sold for purposes related to trade or direct investment in plant and equipment but not for such other purposes as buying shares on the secondary market or short-term foreign borrowing. Domestic savings are already so high that the increment of foreign finance is unlikely to be invested as productively. A partly closed capital account helps to prevent the structure of long-term relations from being disrupted by short-term-oriented entities playing by different rules, such as those of a formal-contract-based system. Such disruption would be especially damaging if free capital mobility were allowed before the development of impersonal mechanisms of monitoring and enforcement.

With this model, East Asia was able to grow fast through the 1980s and into the 1990s, reaping the gains of high debt-to-equity ratios, coordinated investments, and low average transactions costs, without falling into more than occasional short-term crises. The internal structure was complemented by two external conditions: western markets open enough to absorb rapidly increasing Asian exports (validating the high level of investment), and abundant foreign direct investment from Japan, especially after yen appreciation in the mid-1980s raised production costs there.

The Surge in World Capital Markets and the Emerging Markets' Boom and Bust

Finance began to surge on a world scale in the early 1990s, reflected in fast-rising ratios of financial stocks and flows to world GDP. The surge had its roots in the US fiscal and current account deficits that began to grow in the early 1980s. The United States financed its external deficits by attracting capital inflows, mostly in the form of foreign purchases of US government debt (especially Treasury bills), denominated in US dollars. At the other end of the US deficits, the surplus countries accumulated US dollars. Their businesses changed their dollar earnings into local currency at their domestic commercial banks, and their commercial banks deposited the dollars with the central bank. The central bank, rather than sit on the dollars and earn no interest, used them to purchase income-earning US assets, notably Treasury bills (or invested them in a third country, which in turn invested in US Treasuries or other assets). This is the process by which the United States was able to sustain its external deficits by creating debt (or credit) without short-run limits, as long as the US dollar was accepted as the main international reserve currency.

In the surplus countries, the accumulation of US assets, particularly Treasuries, boosted the central banks' foreign exchange reserves. Between 1982 and 1996 the world's central bank reserves rose by well over 200%. This provided the foundation for a surge in world liquidity. With sterilization difficult for the reasons given above, the increase in reserves permitted the commercial banks to expand their lending, generating a boom. The process of rising reserves in surplus countries then led, in some cases, to excessive credit creation, overheating, excess capacity, and asset inflation, followed by crisis. East Asia has experienced two rounds of

this process during the late 1980s and 1990s, first in Japan, then in Korea and southeast Asia.

Japan ran large current account surpluses through the 1980s, especially with the United States. By 1986, the surpluses had become so large—matching the excess of Japanese savings over investment—that Japan could not export enough capital to the United States and Asia to prevent the surpluses from boosting reserves by 200% in two years (1986 to 1987). The reserve expansion swelled the Japanese bubble—a surge of investment, share prices, and property values up to 1990, accompanied by an outpouring of capital in the forms of foreign direct investment, portfolio investment, and bank lending, much of it to East Asia. By 1990, the credit boom had led to overcapacity throughout the economy. Overcapacity put downward pressure on prices and profits. Compared to prospective declining earnings, stock market and property valuations looked wildly inflated. Wholesale prices began to fall, raising the real burden of debt. The economy entered a slump from which it had not recovered 10 years later.

This whole sequence of events would have been unlikely under the Bretton Woods regime (from the postwar years to 1971–1973). Had the dollar remained linked to gold, such that holders of dollars could exchange them at a fixed rate for gold, US external deficits would have caused a fall in US gold reserves as foreign central banks exchanged dollars for gold. The fall in gold reserves would have caused a contraction of bank lending in the United States. The fall in bank lending would have squeezed domestic demand, reducing the demand for imports and increasing the supply of exports, reestablishing current account balance. Meanwhile, Japan's external surpluses would have boosted domestic lending and domestic demand, raising the demand for imports and decreasing the supply of exports, also reestablishing external balance. Hence, the rise in Japan's reserves would have been matched by a fall in US reserves, and the resulting price level and aggregate demand changes would have produced a reverse flow of reserves and an elimination of persistent imbalances. In the post–Bretton Woods world, however, where reserves are created by US government debt that other countries allow as legal reserves, there was no such discipline on the US government. It went on financing its external deficits by selling US government debt almost indefinitely. The expansion of reserves in Japan due to Japan's external surpluses was therefore not matched by a fall in US reserves. Consequently, the world base for credit expansion rose (R Duncan, "The Origin of Economic Bubbles," unpublished).

By the early 1990s, the United States was still running large external deficits financed by capital inflows, but the domestic economy was in recession, unable to use the sizable inflows domestically. Hence, the United States became not only the biggest recipient of capital inflows but also a major source of capital outflows as US investors bought foreign assets, especially stocks. It became the world's great savings entrepot. Meanwhile, the Japanese economy was still running large external surpluses and accumulating reserves, but because Japan's recession was much more severe than the United States', its banks were under great pressure to lend abroad. Europe suffered from low growth and high unemployment, and the

Nordic countries experienced a serious banking crisis, all of which encouraged European banks to diversify outside Europe. All three components of the core, therefore, were engaged in a process of outward investment chiefly financed by credit creation on the basis of rising world reserves, itself based largely on rising US external debt.

With recession throughout the OECD world,[3] international banks and fund managers came to regard emerging markets as the place to make high rates of return on investment and lending. Many emerging market countries carried out far-reaching financial liberalization in the late 1980s and 1990s, including opening the economy to inflows of foreign loans and portfolio capital. Propelled by the dynamics described above, foreign capital flooded in. The capitalization of stock markets of emerging market countries nearly doubled as a proportion of world capitalization between 1990 and 1993 (Aitken 1998).

The inflow of foreign funds would bring greater stock market price stability in emerging markets, said the experts, because stock prices would be more firmly based on economic fundamentals, thanks to the longer time horizons of institutional investors. What resulted, however, was a boom in emerging market stock prices followed by a series of collapses. The money managers herded into emerging markets in the name of diversifying their portfolios, which raised asset prices, which strengthened the argument for more investment and more diversification. Concurrently, these countries were privatizing and liberalizing in accord with the Washington Consensus. Investors interpreted the rise in asset prices as a vindication of those policies, reinforcing the herding of policy makers around the Washington Consensus. Stock market bubbles and policy-making bubbles reinforced each other (Krugman 1995).

The result was a strong correlation between the capital inflows to different emerging market countries, despite the diversity of policies pursued by those countries and the differences in the soundness of their economic fundamentals. The correlation became more pronounced as the volume of flows increased in the 1990s (Aitken 1998; Pettis 1996, 1998).

The Build-up to Crisis in East Asia

Financial Opening In the late 1980s and 1990s several East Asian governments, with Thailand in the lead, lifted most restrictions on capital mobility. (In a longer treatment, the Indonesian case would receive separate attention.) They allowed free inflow and outflow of foreign capital, eased restrictions on the entry of foreign banks and investment houses, and accelerated domestic financial liberalization as well. This happened in the space of a few years. Little attention was given to strengthening impersonal or arms-length methods of bank regulation and supervision—which had previously been achieved through relationship ties. Suddenly, established Asian banks that had been protected from competition and

[3]Organisation for Economic Co-operation and Development.

had limited experience of foreign financial markets found themselves able to borrow in those markets. New banks, often managed by people with no banking experience at all, rushed to reap the profits of foreign borrowing. Restrictions were lifted on the neoliberal assumption that if the foreign borrowing was private-to-private it could be presumed to be safe and productive.

Capital Inflow As East Asian governments liberalized and opened the financial system, foreign capital flooded in during the 1990s, attracted by fast growth, high interest rates relative to the cost of borrowing in the core economies, and stable exchange rates with the US dollar (which eliminated the risks of a devaluation loss on investment). It surged after the Mexico crisis of 1994–1995, when the whole of Latin America looked shaky. Private inflows to Korea, Thailand, Malaysia, Indonesia, and the Philippines amounted to $40 billion in 1994 and over $100 billion in 1996, twice as high as the consolidated current account deficit. Some of the capital went into direct investment in manufacturing as core country firms, especially Japanese firms, responded to intensifying worldwide competition by acquiring lower-cost Asian manufacturing sites for simpler products. But most of the capital inflow took the form of bank loans and portfolio investments with short-term maturities, especially from Japanese banks anxious to compensate for their limited domestic lending possibilities. And more and more of it was invested in assets prone to bubbles, notably stocks and real estate.

Financial Fragility With a relationship-based system of governance and surging short-term inflows during the 1990s, East Asian countries were in the position described by an Indonesian economist: "It's as if the Government had gotten rid of the policeman at every corner, but didn't bother to put up stop signs or lights. The traffic moved faster, but was prone to accidents" (quoted in Passell 1998).

The inflow of foreign funds increased the reserve assets of the domestic financial systems. Thailand's reserves increased at 15–25% per year in 1984–1986, 40–55% in 1987–1990, and 15–25% in 1991–1995. The domestic financial systems were not able to offset or sterilize the increased foreign exchange reserves. The leveraging of unsterilized foreign capital inflows resulted in the dramatic investment surge in East Asia through the 1990s, with investment-to-GDP ratios 5–10% higher than in the preceeding 15 years. Thailand in 1993–1995 was the extreme case, with gross domestic investment at 45% of GDP; Korea's was 37%, still extraordinarily high.

By the mid 1990s, East Asia had three major sources of financial fragility. One was fragile corporate finances, because of above-trend investment and the high share of debt finance (Wade 1990, Haggard & Lee 1995, Wade & Veneroso 1998). The second source was banks that were fragile because of lending against bubble-driven asset values. The third source was a balance of payments that was fragile because of excessive short-term foreign claims relative to liquid foreign assets,

or excessive short-term debt relative to foreign exchange reserves. "Excessive" means anything near or over 100% of foreign exchange reserves, because at that point foreign short-term creditors know that if they are last to call their loans and convert back into US dollars or yen, the reserves may not be sufficient for them to be repaid (Rodrik & Velasco 1999). This is the condition for a panicky pullout and a forced devaluation. Korea's external debt, the majority of it short-term, ballooned from very little in 1990 to around $150 billion in 1996, justified in the name of the great slogans of 1990s Korean politics, "let the free market work!" and "globalize or die!" By 1996, Korea's short-term debt to foreign exchange reserves was over 200%, Indonesia's over 150%, and Thailand's just under 150%.

In short, East Asia's continued high growth rates during the 1990s concealed a change in the source. By the mid 1990s, an appreciable part of the total was bubble growth rather than real growth, in the sense that company profits and debt repayment came to depend increasingly on rising asset prices. Conjunctural shocks then kicked in.

Conjunctural Shocks In the mid 1990s, returns on investment in the United States rose, making emerging markets less attractive. And in 1996 East Asian exports suddenly faltered. Slowing world growth was partly to blame. World manufactured export growth fell from nearly 9% a year in 1990–1995 to 2% in 1995–1996. Also, Japan and China, which together constitute four fifths of the East Asian GDP, suddenly slowed in 1996 and 1997, dimming prospects of exporting to them and intensifying competitition against their exports in third markets. The recent devaluations in China and Mexico put downward pressure on East Asian export prices. The appreciation of the dollar against the yen in 1995, and therefore of East Asian currencies linked to the dollar, was a major blow to exports. For example, Thailand's manufactured export growth fell from 21% a year in 1990–1995 to −1.6% a year in 1995–1996. Underneath the conjunctural events were longer-term problems of (*a*) sustaining the growth of leading sectors in the face of growing excess manufacturing capacity worldwide and (b) catching up as East Asian countries approached the technological frontier.

Maintaining the Peg Why did Thailand, for one, not devalue by 1996 (since Thailand had been running substantial current account deficits, bigger than the others', since the early 1990s)? In the Thai case, the answer involves the finance ministry's losing its earlier technocratic independence and becoming obligated to those who could bring down the government. Hence the finance ministry did not accept a confidential World Bank urging for a small, orderly devaluation in 1996. Even a small devaluation would have hurt those in the political elite to whom the Thai finance ministry was obligated because they had borrowed abroad without taking out protection against a devaluation (i.e. without hedging). But politicization of the finance ministry was probably secondary to the worry that a so-called small and orderly devaluation would turn out to be neither.

International investors commonly respond to a 10% devaluation (or widening of the band) in an emerging market not by saying, "This devaluation looks about right because the currency was 10% overvalued, so we'll keep our money in," but by saying, "This shows the government has lost credibility, so we'll pull our money out." More generally, breaking the currency peg might disrupt the inflow of (short-term) capital, and the Thai economy, like the Korean and the Indonesian economies, had by this time become heavily dependent on these inflows even for refinancing debt. So the peg was maintained, at great expense to exports. This is a key link between the real economy and the financial determinants of the crisis.

Indeed, it might be argued that by the mid 1990s, a new but largely implicit development strategy had emerged in some of the East Asian countries. Whereas the old strategy had been based on a highly competitive export sector, for which a degree of undervaluation of the currency was helpful, the new one, as the currencies rose with the dollar against the Japanese yen and German mark after 1995, focused on continuing to attract foreign capital as the principal motor of development. The debt was by then so large that its refinancing became a central objective of government policy, which meant avoiding anything that would undermine the confidence of foreign investors—including devaluation (Putzel 2000).

More Financial Fragility For a time the governments' assurances about maintaining the currencies, along with the gestalt of "miracle Asia" and worries about Latin America, kept the disturbing trends in corporate balance sheets beyond foreign investors' attention. Indeed, private foreign inflows continued to rise, and at decreasing risk premiums, up to mid 1997. By then the degree of financial fragility was such that quite small shocks could trigger a gestalt shift from "miracle Asia" to "meltdown Asia" (Wade 1998a).

The Costs of Overinvestment The Asian crisis was a crisis of overinvestment—in real estate and stocks relative to sustainable valuations ("asset bubble"), as well as in manufacturing relative mainly to conjuncturally falling demand growth and secondarily to long-term worldwide overcapacity in manufacturing. The Mexican crisis of 1994–1995 had a similar root—a domestic credit boom generated by unsterilized foreign capital inflows, which were attracted by proximity to the United States and by anticipated economic success. But the credit boom in Mexico vented itself in a surge of imported consumer goods, reflecting high consumption propensities, whereas the Asian credit boom vented itself more in excess investment, reflecting high savings propensities. Of the two types of crises—one driven by excess consumption, the other by excess investment—an excess consumption crisis is generally easier and quicker to recover from, because it entails less debt and excess capacity to be worked out of. And indeed Mexico after

1994 did recover more quickly than Asia after 1997.[4] The severity of Asia's crisis was the other side of two of its great developmental strengths relative to Latin America: its huge savings and its high debt-to-equity ratios. They financed high investment, which caused fast growth, which attracted excess foreign capital in the form of debt, which financed excess investment. Once the crash began, the external crisis (the forced devaluation) and the internal crisis (the contraction of credit and the resulting debt default) ricocheted around each big firm's balance sheet, interacting in a vicious circle, to yield not merely crisis but collapse. The contractionary policy response imposed by the IMF only made matters worse.

Recovery The only recovery solution was some combination of debt reduction and increased foreign exchange earnings. In principle, the debt burden could be reduced by default, rescheduling, faster growth, or inflation; and foreign exchange earnings could be increased by a lucky increase in export prices or by squeezing the domestic economy to reduce imports and shift more resources into export production. In practice, the squeeze solution dominated. It solved the external crisis sometime in 1998, as foreign exchange reserves ballooned and exchange rates stabilized at, in most cases, around 70% of the pre-crisis level. But it worsened the internal credit contraction crisis, which continued into 1999. By mid 1999, two years after the onset, the recovery of production and incomes looked fragile and uneven, more like a W than a V.

[4]If recovery from an excess-consumption crisis is easier than recovery from an excess-investment crisis, how do we explain the Latin American crisis of the 1980s? That was an excess-consumption crisis, yet recovery took most of a decade. Latin America's per capita GDP growth in 1980–1989 was −0.5%, whereas East Asia's was over 6%. The contrast between Latin America in the 1980s and Mexico/Latin America in 1994–1995 depends on the additional variable of world liquidity. The 1982 crisis came at a time of sharp contraction in world liquidity. The hike in interest rates and the slowdown in export markets meant that Latin America's debt burdens kept growing faster than the countries' ability to repay, and the countries paid more in debt servicing than they brought in (negative net resource transfers). Due to the drying up of world excess liquidity, no new private capital came in voluntarily as bridging finance. Rather, the governments screwed down the domestic economy to release resources for debt repayment, and the IMF and World Bank/Interamerican Development Bank provided official finance. This combination allowed enough debt servicing to avoid a formal default. It was seven years before voluntary private flows resumed in response to a combination of expanding world liquidity and Brady Plan rescheduling and conversion of loans into tradable securities. The Mexican crisis of 1994–1995 occurred at a time of expanding world liquidity, so United States/IMF bridging finance and some debt forgiveness were quickly arranged and voluntary private finance flowed back within a year. Also, the United States had a more direct interest in a speedy Mexican recovery in 1994–1995 than it had had in a speedy Latin American recovery in the 1980s.

Causality

How do we know that the culprit is private capital inflow surges blowing out a credit boom, and not bad bankers or the other villains of the Asian cronyism story? The first part of the answer lies in the striking correlation, mentioned above, between capital flows across emerging markets. During the 1990s, private capital inflows to developing countries typically grew at 10–20% a year. But they surged twice, in 1993 and in 1996, both times doubling the inflow of the previous year. Each surge was followed the next year by major financial crisis in emerging markets, the first time in Mexico and Latin America, the second time in Asia (Howell 1999).

Second, it is well known that bank regulation and enforcement of prudential limits becomes very difficult in the face of a capital inflow surge, even in a sophisticated, rule-based (not relationship-based) financial system with skilled financial managers. As former Federal Reserve Chairman Paul Volcker (1999) explained, "In benign periods ... banking supervision and banking regulations have very little political support and strong industry opposition. That's true in developed countries as well as developing countries which by the nature of things are bound to be behind the curve of market developments, best practice and strong institutions." There is no need to resort to Asian specifics to explain why, given the inflows, Asian bank regulators were less than effective. The inflow process itself undercuts the ability of regulators to regulate (Blecker 1999, UNCTAD 1998).[5]

Third, the entire financial system of the typical emerging market economy is no bigger than an average American regional bank. Tiny changes in the share of world capital flows going into a particular country can swamp the system, however skilled and uncronyistic the bankers and monetary authorities.

If private capital inflows were the main culprit, how do we know that opening the financial system was the crucial factor behind the inflows? How do we know the crucial factor was not lack of transparency, weak prudential regulation, moral hazard, or those other faults that, according to the usual story, led responsible, rational foreign bankers and investors to lend more than they would have lent had they known the truth, and had they not had grounds to believe the loans were implicitly guaranteed? As shown above, the usual story falls down at the first nudge, above all because these factors do not differentiate the countries that had a crisis from those that did not. The most affected countries (Korea, Thailand, Malaysia, and Indonesia, which all had negative growth in 1998) were not worse in these respects than the least affected countries (China, Taiwan, India, and the rest of South Asia, which had positive growth in 1998). What does differentiate

[5] Volcker's argument about the generic difficulties of bank regulation, even in sophisticated and transparent systems, is borne out by the behavior of US Savings and Loan banks in the 1980s. They had been restricted to housing finance, the safest and least innovative form of banking, but suddenly the restrictions on both their deposit taking ("Regulation Q") and their lending were lifted. They went wild, producing the fiasco of bad banking known as the Savings and Loan crisis. The recapitalization of the banks took over 3% of the US GDP.

the most and the least affected countries is capital mobility. All of the most affected countries opened the financial system to capital flows more or less fully by the mid 1990s. The least affected have in common restricted capital mobility, with capital transactions more limited to trade and direct investment. During the 1990s, the countries with restricted capital flows did not experience anything like the capital inflows of those with open capital accounts; their short-term debt to foreign exchange reserves remained much lower, and their corporate sectors were less vulnerable to exchange rate, interest rate, and investment shocks (Gray 1999), so they experienced less outflow.

If this evidence is not sufficient, try a thought experiment. Would Korea have been better off with short-term debt to foreign exchange reserves in mid 1997 at, say, 50% than above 200%? Yes. Would it have lost much in terms of social profit by cutting back its short-term inflows? No, because by the mid 1990s, most of the inflows were fueling a speculative industrial capacity bubble. But putting a ceiling on the ratio would have required the government to limit the inflows produced by uncoordinated decisions of private entities that did not have to take account of the social risks to which their private decisions exposed the rest of the society.

In short, Asian governments are deeply implicated in the crisis for opening the financial system quickly in the 1990s without linking the pace of the opening to the build-up of effective rule-based (rather than relationship-based) governance of financial markets, including institutions of accounting, auditing, rating, and legal cases and codes, in the false belief that if the capital was moving private-to-private it must be safe. Certainly company performance was deteriorating by the mid 1990s across the region. But the major problem was domestic financial structures not robust enough to handle the heavy shocks to which they were exposed by precipitous financial opening in conditions of surging world capital markets. Had the governments not abandoned some basic principles of the East Asian model—above all, the principle of strategic rather than open-ended integration into world financial markets—the economies would probably not have experienced a serious crisis, although they would also have grown more slowly.

On the other hand, the deeper causes of the Asian crisis lie in the core economies and their governments, especially that of the United States, and in the kind of international financial system they have created. The US decision to break the link between the dollar and gold (rather than cut expenditure for the Vietnam War and the Great Society) allowed persistent imbalances to build up in the world economy because increases in surplus countries' reserves were no longer matched by falls in reserves of the United States, the main deficit country. The United States' reluctance to rein in its external deficits, and its preference to finance them by creating debt that other countries accumulated as foreign exchange reserves, then produced (given the post–Bretton Woods payments system) a surge in world liquidity that eventually produced excess capacity and financial fragility worldwide. Both Japan's boom and bust and the later Asian miracle and bust were manifestations of the same systemic process. Explanations that locate the causes within the crisis countries occlude this basic point.

A POLITICAL SCIENCE AGENDA

Why did the governments of the crisis-affected countries open the financial system in the 1990s, and why did the governments of the less affected countries [notably Taiwan (Chu 1999)] do so less? Why did the governments of the crisis-affected countries sit on their hands as the debt built up, why did they allow domestic and foreign bankers to blow up asset and industrial capacity bubbles, why did they give up coordinating investments—why did they depart from the East Asian model? Some of the explanation can be found in the inner wheels of national politics and class (see Gills 1996, Woo 1991, and the works on the crisis cited above). The power balance between manufacturing, finance, and the state was changing during the 1990s in favor of private finance; parts of the state itself became increasingly beholden to financial interests and private (Thai, Korean) financiers saw their interests as aligned with those of foreign financiers, all wanting unrestricted cross-border financial transactions.

This makes an important research agenda for comparative politics. Especially interesting is the politics between those whose interests remain rooted in the national territory (and therefore related to the success of the national economy), the growing number of those whose interests lie in maximum mobility of assets and who have less stake in the success of the national economy, and those (including some powerful manufacturers, domestic and foreign) whose interests are in between. The crisis has led the manufacturers, notably in Thailand, to press for more state help for industrial upgrading—not only state backing for higher quality standards but also a more active promotional role, even as the governments talk the neoliberal language of reducing state involvement in industry.

But more than the power balance is changing. There is also a longer-term trend for average transaction costs to rise as the economies become more complex and open and the number of transaction partners rises (Li 1999). Relationship-based systems become less effective as average transaction costs rise, and the spread of neoliberal ideas erodes their legitimacy. This may generate a movement away from a relationship-based system, including abrupt removal of restrictions such as capital controls that had helped to stabilize the system. Such a movement could cause the sort of governance vacuum in financial markets that emerged in Asia during the 1990s.

For international political economy, the issue is the credit bubble that is rotating around the developed and emerging market countries, blowing out periodically at high cost to people's lives. The bubble is driven by excess world liquidity generated in the core economies. With higher excess comes higher volatility of financial flows within and between regions. The control of this liquidity is increasingly concentrated in a small number of investing institutions. Small changes in their portfolios between regions, countries, and sectors can trigger enormous volatility in any one country, swamping its regulatory rules and institutions. It is quite misleading to say, with the US Treasury and the IMF, that the solution to the volatility is "sound" financial institutions in emerging markets, because the inflows themselves can easily undermine the capacity to maintain soundness. The solution is to curb the inflows.

This is exactly what the great configuration of financial interests in the west, whose power to shape national policies and international regimes has grown as excess liquidity has grown, does not want. Here the international political economy agenda merges into an American political agenda. The configuration is led by what could be called the Wall Street–Treasury complex, analogous to the military-industrial complex (Bhagwati 1998, Kristof with Sanger 1999). It connects Wall Street, the US Treasury, the US Congress, the IMF, the World Bank, and the US economics profession (Frey et al 1984, Kolm 1988), with the City of London and the UK Treasury as an offshore adjunct. This complex is the seat of the great campaign of the late 1980s and 1990s to open up emerging markets to free capital mobility, with the US Treasury at the helm (Wade 1996a, 2000).

The campaign has been played out partly in hardball bilateral negotiations, such as the Financial Services Talks between the US Treasury and the Korean Finance Ministry during 1990–1992. These began with specific issues (such as raising or eliminating Korea's 5% limit on foreign ownership of Korean firms) and evolved into demands for fundamental structural reform because, in the words of a US negotiator, "it became apparent that many of the difficulties faced by foreign institutions in Korea were connected to structural distortions in the financial sector resulting from the highly regulated nature of the system and the government's heavy-handed intervention" (Fall 1995).

The campaign has also been played out in multilateral forums such as the IMF, the GATT/WTO, the Multilateral Agreement on Investment, and the Asia Pacific Economic Council (APEC; Wade 1998b). This campaign demonstrates US "unilateral internationalism" in full force. The Clinton administrations of 1993–2000 and the post-1994 Congress have used international organizations such as the IMF and APEC as tools to advance US foreign policy objectives insofar as they cloak the objectives with multilateral legitimacy and spread the costs over other states—but not insofar as the United States has to compromise its own margin of maneuver by honoring obligations of membership that run against its immediate interests.

The US Treasury virtually dictated the conditions attached to the emergency IMF financing arranged for Thailand, Indonesia, and Korea. Those conditions were meant to force the crisis countries, which by then had no bargaining room, to undertake structural changes intended to create institutions and rules closer to those of Anglo-American capitalism and more acceptable to US business. Small, elite groups within the crisis countries had wanted to move in this direction anyway, as noted above, but even the Korean negotiators were pushed much farther than they wanted to go. The disbursements of the emergency financing were tranched against compliance with the conditions. The US General Accounting Office established a task force of 31 people in 1998 to investigate Korea's and other beneficiaries' compliance with IMF conditions.

In the Mexican bailout of 1994, by contrast, the US Treasury and IMF assembled a massive and credible international rescue package of $50 billion to stabilize the peso at once, and the government did not promulgate an attached reform program (privatization and faster liberalization of the telecommunications sector and financial services) until several months after the credit line became available.

As a result, the forced devaluation did not interact with domestic credit contraction nearly as much it did in Asia. Why the difference in policy response? Mexico had already done much of what the United States wanted Asia to do. Also, the United States had a strong national interest in seeing a quick recovery on its southern border, whereas its national interest in Asia was not in quick recovery but in opening markets, so that American firms could operate in East Asia as easily as Japanese firms did.

The United States–led campaign for free capital mobility worldwide is not just a reflex of sectoral financial and business interests. Wall Street's ascendancy in US politics during the 1980s and 1990s has accompanied fundamental shifts in values. Above all, the Depression/Bretton Woods idea that society should shelter the individual from certain risks was supplanted by the idea that social arrangements should allow the citizen-investor-gambler to profit from risk. This means that all citizens should provide for their income in old age by building wealth in the stock market, in contrast to the Depression-to-the-1970s view that the government should provide a minimum income to be financed from taxes collected from the current generation of workers, whether those workers wished later to enjoy the same protection or not. The shift in the principle of pensions—which has gone much farther in the United States than in continental Europe or Japan—is driving a basic realignment of interests in the United States away from the protection of labor income (from which are paid the taxes that finance a pay-as-you-go pension scheme) toward the protection of capital income (from which stock market investors benefit).

Wall Street's dominance is related to this realignment. Wall Street has been able to shape the Treasury's agenda especially decisively during the (Democratic) Clinton administrations, for reasons partly related to the funding base of the Democratic Party (Ferguson 1995). But, funding of the Clinton presidency aside, the US Treasury sees free capital mobility worldwide as a matter of vital US national interest, for when so many US citizen-investor-gamblers depend on the stock market and stock-market-invested pension and mutual funds, US money managers must be able to move finance without let or hindrance wherever returns are highest. On the other hand, opening other countries' financial sectors causes no harm to US domestic interests (Wade 1998–1999). Perhaps, in addition, it has occurred to the Treasury, the State Department, and the security apparatus that the debt trap can be operated to US advantage: As countries build up their private debt, they become more and more subject to the threat of capital pullout, and the US government can influence the likelihood of pullout and use its influence to advance US foreign policy objectives, such as boosting the position of US firms in Asia. That question cannot be answered yet. We do know, however, that the Treasury said virtually nothing about the dangers of financial opening in its dealings with Asian countries (Kristof with Sanger 1999).

By some measures, controlling for skill levels in the population at large, the US federal government is among the least competent in the world. The interesting question is how the United States nevertheless manages to articulate a substantive definition of its national foreign economic interest, to keep the definition stable,

and to implement it to a degree that makes the German and Japanese governments look feeble. In the Asian crisis, the Treasury managed largely to exclude all the other agencies (State, Commerce, CIA) from the table; but how (Gopinath 1999)?

In terms of solutions, one element, as noted, is capital controls. But larger scale changes are needed to dampen the tendencies toward booms and busts. The world needs a new system of international payments, such that each country could pay for cross-border transactions in its own currency rather than having to earn a foreign currency (mainly US dollars) in order to pay for goods or repay borrowings. This could be achieved by an international clearing agency that would clear payments between countries internally, between one account and another, without the payments having to go through an open foreign exchange market (Wade 1999). The world also needs a substantial rise in wages in the large developing economies in order to reduce the amount of world excess capacity. China, Vietnam, Indonesia, and Mexico—the countries that account for the largest part of foreign direct investment in low-wage countries—ought to reach a collective agreement to impose on incoming foreign firms a minimum wage of, say, $10 per day instead of the current $3 or less. These countries could justify their action to hostile foreign investors with the argument Henry Ford used to justify his decision to raise the wages of his workers—so that they could afford to buy his cars. Western governments and multilateral organizations such as the World Bank should encourage unionization and democratization for the same reason—to encourage the growth of global wages in line with global output and limit the tendency toward excess capacity. Environmental protection would have to be stepped up at the same time.

The events described in this essay are one episode in a bigger pattern stretching back to the birth of global capitalism in the 1840s. Since then, there have been several periods of surges in world liquidity, cross-border capital flows, and trade (Wade 1996b). Each period has created a justifying ideology similar to our current "globalization." It claims that the world has moved permanently into a new and more promising era; that the growing density of market relations allows more stable as well as faster growth; that a single set of policies—liberalization of markets for goods and finance, small government, and fiscal discipline—is best for capturing the benefits of globalization. According to the new ideology, countries that adopt these policies and accompanying free market institutions can expect reliable inflows of foreign capital; countries that plunge into crisis or fall behind do so because of their own mismanagement. Angell proclaimed some of these ideas in *The Grand Illusion* (1911). The world economy had become so interdependent, thanks to science, technology, and economics, as to make national independence an anachronism (the grand illusion), and wars between modern nations "an impossibility," he said (three years before World War I). The *Economist* said about Japan shortly before the crash in early 1990, "What Japanese investors have become aware of is the dramatic way Japan's blue-chip companies have changed the sources of their earnings through restructuring. This has made their profits too erratic to give any meaning to rigid measures such as a p/e ratio. Instead investors

have started to assess a company's future stream of earnings by looking at the total value of a firm's assets.... The implication is that shares may be underpriced." Today, the IMF promulgates globalization ideas constantly.

> Countries that align themselves with the forces of globalization and embrace the reforms needed to do so, liberalizing markets and pursuing disciplined macroeconomic policies, are likely to put themselves on a path of convergence with the advanced economies, following the successful Asian newly industrialized economies. These countries may expect to benefit from trade, gain global market share, and be increasingly rewarded with larger private capital flows. Countries that do not adopt such policies are likely to face declining shares of world trade and private capital flows, and find themselves falling behind in relative terms. (IMF 1997:72)

According to Weber (1997), globalization has made for "a more flexible and adaptive economy that adjusts to shocks more easily and with less propensity for sparking a new cycle." On the other hand, "The ... argument that complex markets might act in synergy and come crashing down together is simply not supported by a compelling logic or empirical evidence." This was published 10 years after stock markets around the world had crashed together, and just as the Asian crisis began, to be followed by the Russian crisis, the Brazilian crisis, and the sharp falls in core economy stock markets in the latter part of 1998. The globalization champions underplay the tendency for the globalization process itself to generate instabilities that bring the surge in liquidity, capital flows, and trade to a temporary end.

Political scientists living in the core economies have a special responsibility to examine the role of core economy governments, banks, institutional investors, and economics professions in generating these instabilities, and to challenge those institutions' explanations of crisis that place the causes far away within the crisis-affected countries.

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